Having an adequate view of an organization's risk profile is an ever-present concern for businesses of all types. For healthcare organizations, this concern has grown into a major focal point as providers are being hit on all sides by uncertainty: whether healthcare reform, the regulatory landscape, changing demographics, or even liabilities stemming from employee retirement plans. These risks should be viewed from a top-down perspective, in aggregate, to evaluate how shifts in the risk profile may affect the business as a whole. We believe Enterprise Risk Management (ERM) is a concept that many healthcare organizations are pursuing as an effective method to strategically and comprehensively evaluate risk. We prefer this definition of ERM:

"Enterprise Risk Management (ERM) is a structured analytical process that focuses on identifying and eliminating the financial impact and volatility of a portfolio of risks rather than on risk avoidance alone. ERM utilizes a process or framework for assessing, evaluating, and measuring all of an organization’s risks."

This framework described by the American Society for Healthcare Risk Management can help a healthcare organization to manage its balance sheet, both assets and liabilities. The standard asset-only or liability-only “siloed” approach fails to quantify potential correlations across the risk spectrum that could in turn impact the entire organization and its goals.

For healthcare organizations, proper evaluation of these risks can help them to maintain credit rating, stabilize days cash on hand (DCOH) and comply with debt covenants of their respective credit providers – pivotal metrics in achieving steady operations. A reliable DCOH level, as well as a stable credit rating, allows an organization to borrow competitively and can help to reduce the costs associated with borrowing. The increased liquidity for the organization can also contribute full circle to the holistic stability of the credit rating. In our opinion, proper attention to these three factors can help an organization prepare in the short term to achieve growth over the long term.

**So how do healthcare organizations look at ERM?**

We define five components of enterprise risk: unrestricted liquidity, capital structure, operations, capital budgeting risks, and defined benefit plans. Taken in aggregate, these five components can significantly influence the credit rating and overall financial health of a healthcare organization. Proper management of these risks can lead to financially healthy organizations, while, conversely, mismanagement of these risks can lead to an unnecessary strain on operations.
When it comes to managing liability portfolios in the healthcare industry, standard practice consists of evaluating finance alternatives based upon a comparison of cost of capital followed by an assessment of the risk of each product alternative. This standard focuses on the liability side of the balance sheet, without necessarily considering the effect that assets have on the fluctuation of said liabilities.

**How does PNC Healthcare measure enterprise risk?**

Within PNC Healthcare, and somewhat contrary to standard practice, we believe in defining the components of enterprise risk as a portfolio of liabilities. For this purpose, risk is bucketed into two categories, interest rate risk and liquidity risk. Interest rate risk covers the gamut of the general level of interest rates, basis risk and tax risk. Liquidity risk measures the put risk associated with debt products and mark-to-market risk associated with interest rate swaps, especially with regard to the potential to reduce DCOH.

Once these risks have been defined and measured, the next step in the assessment is to stress test the liabilities and their potential negative impact (in adverse scenarios) on a healthcare system’s balance sheet and income statement. The components of the operations that can be evaluated with respect to these risks include:

1. Financial assets on and off (pensions) balance sheet
2. System operating cash flow
3. Major capital investments or acquisitions

From an investment perspective, the goal is to measure and determine the impact of changes to asset allocation and liability portfolio composition on organizational risk. A model should take a holistic view of the balance sheet and income statement such that you can manage risk (measured as probability of maintaining credit ratings or other user-defined metrics) by adjusting the levers of asset allocation, liability portfolio, and major capital projects.

**What steps can be taken to mitigate the impact and volatility of enterprise risk?**

Each healthcare organization has a different risk profile with its unique circumstances. Here we would like to provide a couple of examples of how existing healthcare organizations took steps to mitigate the impact and volatility of their enterprise risks.

**Case Study 1:**

Recently, a large healthcare system was faced with a deteriorating operating environment. Because of this, the healthcare system decided to migrate some of its “risk” balance sheet investments to a more conservative, short-duration fixed income portfolio to ensure that the system had adequate liquidity to manage its cash flow and operational needs. This helped improve the healthcare system’s DCOH metric and mitigate the effect the deteriorating operating environment had on its credit rating stability. The healthcare system is also evaluating a liability-driven investment strategy for its defined benefit pension plan, which will help mitigate the variability of the liability.

**Case Study 2:**

A large regional system wanted to increase the impact that its longer-term investment portfolio had on ability to fund strategic operations. The system maintained adequate liquidity through a large position in US Treasury and Agency securities. As a result, it decided to fund a private investments portfolio to ensure that the operating assets pool was generating additional “utility,” in the form of incremental return, to support these strategic initiatives. In this case, the chief concern of the system was related to shortfall risk, in that it did not want the returns on its assets to fall short of being able to fund these expenditures.
Enterprise Risk Management and Healthcare Organizations

Conclusion

Incorporating both sides of the balance sheet can be essential to properly managing a healthcare organization's enterprise risk in a holistic manner. Furthermore, doing so can help to maintain a level credit rating, stabilize DCOH, and comply with debt covenants. By performing an ERM analysis, a healthcare system can calibrate its investment portfolio to help ensure that it is optimized relative to its liabilities. Over the near term, this can help to provide continuity of operations; over the long term, we believe that this can help to fuel organizational growth.

For more information, please contact your Investment Advisor.


2 “Basis risk in finance is the risk associated with imperfect hedging. It arises because of the difference between the price of the asset to be hedged and the price of the asset serving as the hedge, or because of a mismatch between the expiration date of the hedge asset and the actual selling date of the asset.” Source: https://en.wikipedia.org/wiki/Basis_risk